Exchanges at Goldman Sachs

M&A in 2023: A complex but optimistic outlook for deal-making

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Allison Nathan: After soaring to record levels in 2021, the global M&A markets slowed markedly in 2022 against a challenging economic environment. So, how did deal activity play out? And what can we expect in 2023?

Mark Sorrell: When you think about the underlying drivers that we've seen really in the post COVID M&A world, I think they're at least as strong as they were. I think what is different is, one, the financing market. And clearly, the macro is also more uncertainty.

Allison Nathan: I'm Allison Nathan and this is Exchanges at Goldman Sachs.

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Allison Nathan: 2022's backdrop of rising rates, economic uncertainty, and geopolitical tensions posed a challenge for M&A. To walk us through the past year and the 2023 outlook for M&A, Stephan Feldgoise and Mark Sorrell, the co-heads of the global mergers and acquisitions business in Goldman Sachs' Investment Banking division join me now. Stephan, Mark, welcome back to the program.

Stephan Feldgoise: Thanks for having us.

Allison Nathan: Stephan, when we last spoke about a year ago, M&A activity had been absolutely shattering records. Today, the environment is very different. We are facing sharply high inflation, interest rates, market volatility. So, how has that more difficult environment impacted deal activity?

Stephan Feldgoise: Sure. And again, thanks for having us. And glad to be back. It's very interesting, it was really a tale of two halves, as I'd describe it. The first half of 2022 continued on the torrid volumes that we saw in 2021. And really, as we headed into the second half of 2022 is when you saw things slow down.

And it was, overall, still quite a good year. If you look at the deal counts and deal volumes, it was on par with what I'll call the five-year averages, excluding the extraordinary 2021. So, from an M&A perspective, it felt pretty good.

Now, private equity had always made up, call it, 30 to 40 percent of the M&A market. And that's really what you saw come to a tremendous slow down in the second half of 2022. A lot of that was driven by the leveraged finance markets and the, what I'll call, inability of private equity to get attractive financing that they had benefited from, frankly, for many years. Not just in 2021, but very low interest rates for a period of time.

That being said, strategic activity remained very robust through 2022. And we've seen large transactions. And in fact, very recently, including today, we started to see some material private equity buy sides and transactions with creative financing.

Allison Nathan: So, in 2023, our economists at Goldman

Sachs are expecting us to avoid recession. But they do still see more volatility ahead. So, what are you expecting for deal activity in 2023, Mark?

Mark Sorrell: Thanks, Allison. And again, it's great to be back. What I would say is we are constructive about the underlying drivers of activity. As Stephan said, we need a well-functioning financing market for a lot of that activity to happen, not all of it, but a good part of it.

And when you think about the underlying drivers on the corporate side, the trend of technology shift is still there. Arguably, it's accelerating. The focus on ESG is still there. Arguably, it is also accelerating. The trend of simplification has definitely been accelerating through 2022.

And the private capital side, the amount of liquidity in the system is as high as it's ever been. The need to deploy is there. So, when you think about the underlying drivers that we've seen really in the post COVID M&A world, I think they're at least as strong as they were.

I think what is different is, one, the financing market. And clearly, the macro is also more uncertain, but not withstanding that, we are constructive.

Allison Nathan: If we stick with this macro environment for a moment, though. Has that impacted the types of deals in the markets?

Stephan Feldgoise: Yeah, look, we've certainly seen what I'll call more regional strategic transactions. So, cross border are down materially. And I think that's probably been the most impacted type of transaction all the way back to COVID, frankly, where traveling was-- just getting to see clients was very difficult. And not to mention, clients negotiating transactions across continents. So, cross border has probably suffered the most.

Strategic issues and focus coming out of COVID has remained top priority supports, i.e., think about repositioning. Think about supply chain. So, a lot of the themes we've talked about previously remain absolutely paramount [UNINTEL]. The question is, can they get things done? Can they finance them?

We'll talk a little bit in the future just about how the valuation paradigm has changed. But most importantly on valuation, how do you think about a dollar of earnings is a discussion we have in boardrooms. And just because the interest rates have gone up, the weighted average cost of capital has gone up. And therefore, fundamental valuation has declined. And we've seen stock markets decline.

But many boards of many companies that demand dynamics, and the fundamentals of the business remain very strong. So, there's a whole valuation dynamic that is impacting all of this. So, it's very sector specific. We've seen the largest down drafts in tech. But we've seen very robust and continued M&A in sectors like industrials, or in healthcare where big pharma is extraordinarily well capitalized coming out of COVID and looking to refill their drug pipelines.

So, as we look to '23, we think there'll be sectors that will benefit. But I don't expect to see a robust return of cross border, which has been most impacted by all of this.

Allison Nathan: And let's talk a little bit more about the financing challenges that you mentioned, Mark. What's going to turn the tide from that perspective?

Mark Sorrell: So, I think let's start with an important point about where is the financing market functioning well? In corporate investment grade, yes, it's more expensive than it was. But there's a very well functioning financing market. And I would note, many corporates carry very high cash balances relative to history. And that gives them strategic flexibility. It gives them flexibility on their capital structure. They can buy back stock. Or they can do M&A.

What I would say is interesting, and Stephan mentioned this, through 2022 we've seen really resilient corporate consolidation activity. And I think it's worth saying that for many of our corporate clients, I think they look at the valuations, which have clearly come down, and they feel incrementally better about deploying their balance sheet for M&A at today's valuations, maybe, than they did 12 months ago. And so, I think that corporate mindset has shift. So, that's on the corporate side.

I think clearly corporate sub investment grade, there is a market there. But it's materially more expensive. On the private markets or in private capital, as Stephan said, that's the part of the market that's been most impacted by financing markets, if you look at the transactions that have been getting done by private equity, many of them are highly structured and they have bespoke capital structures. That's one category. Maybe they have a lower level of leverage and potentially accessing the direct lending market for that leverage.

In some transactions, private equity clients are funding all equity and then refinancing later. And in some of those, they may be looking at smaller deal sizes as well where they can use more equity in the mix for less leverage. So, that's, I think, probably a consistent picture.

And I think when you think about private equity, the kind of deal that you were seeing a lot of in the first half of the year was public to privates, which are often long duration transaction signing to closing. And really need a strong financing market. We've seen some. But not nearly as many in the second half of the year. So, there's a good example, I think, of the type of transaction that generally needs a robust financing market.

Stephan Feldgoise: And we don't need interest rates to go back to where they were to have a robust private equity M&A market. We need predictability and some degree of stability for the underwriters of debt to be able to price and put terms in place that, A, the banks are comfortable with. But, B, the private equity firms are comfortable with. And that's really the issue.

Avoiding hung deals, as they're called, where you can't syndicate a debt, which obviously happened in 2022, is the key to returning to what I'll call robust and reasonable financing markets. Obviously, it impacts valuation. But robust and reasonable financing markets. Again, stability, not necessarily low interest rates.

Allison Nathan: Mark, do you have something to add.

Mark Sorrell: I 100 percent agree with the importance of confidence in where financing can clear the market. I would also say for clients, once we have that greater degree of confidence, our clients will have a greater degree of confidence of where valuations are going to settle down. And I think one of the challenges at the moment, and I'd say this is particularly the case in Europe, is the gap in valuation between the public market and private market valuations, has really gapped out. It's widened a lot this year. That poses a challenge for clients thinking about that relative valuation gap.

And as Stephan said, I think when financing markets settle, there will be greater confidence in where debt can clear. And there will also be greater confidence in where valuations are going to settle. That's why we think at that point, deal activity will pick up. And that will feed on itself.

Allison Nathan: Right. Valuations have been somewhat, actually, the tailwind that has counteracted a bit of some of these headwinds. The dollar, also, has a been a bit of a tailwind when you think about the increased purchasing power of US buyers for overseas companies. So, where do you see opportunities leveraging these tailwinds?

Mark Sorrell: I think that when you look at the valuation gap between the US and Europe, which is the main cross border market that we focus on, it's undoubtedly the case that the valuation gap between the US and European public markets has widened. And then you have the currency overly on top. So, it's undoubtedly the case that for our corporate clients in the US, when you're looking at relative valuation around the world, Europe looks relatively more attractive than it did even before you overlay currency.

Having said that, the macro is also challenging in Europe. And we need to recognize that. So, I would be balanced around that for it.

I think there's a separate driver in private markets. In private markets you have a large number of US dollar denominated funds in the US. Traditionally, those funds would have deployed entirely in the US market. We see more of those funds looking in Europe. That's a valuation point. But that's also a currency point given they have dollar funds. And we have seen US private equity firms, I would say, particularly in the midmarket, looking at European assets for the first time. And I think that's something that we will certainly see a lot more of, I think, as this cycle turns.

Allison Nathan: So, in this type of environment though, has there been a type of structure or transaction that's been more prevalent?

Stephan Feldgoise: So, an important part of the market in '22, and frankly, for the last several years has been what

I'll call the structured transaction. That could be a spin off. That could be a split off. Corporate simplification is the overarching way we define that theme. That's driven by a number of things. One, investors feel strongly that it's much easier and more digestible for them to invest in companies where they can view a single sector and say is that going to be a beneficiary or one that I might not want to invest in? So, simplification is going to get a big investor focus.

The other thing is just we see significant disparity in the way different businesses trade. And when you think about conglomerates, they could have a very disparate businesses that might trade at high multiples or low multiples. And companies, many of them driven by the view that breaking up creates value for their shareholders to allow certain businesses that trade differently to trade at the appropriate multiple. The markets have, unfortunately, treated conglomerates with a discount. And realizing that discount for their shareholders has been a big driver of that simplification.

So, you think about many of the transactions, largest transactions, we talked about large strategic transactions, have been either large companies just simplifying themselves, i.e., splitting up. Or doing structured transactions like spin mergers where they will separate a business and simultaneously merge it with another to create synergetic value in those businesses.

Allison Nathan: And Stephan, another bright spot has been mega deals. Deals that are very large, exceeding $10 billion. We've seen Microsoft's acquisition of Activision Blizzard. We've seen Broadcom's bid for VMware. So, how has the market for larger volume deals changed? And why has that proven more resilient?

Stephan Feldgoise: Number one, financing. Large companies will tend to be more in the investment grade category. And that market is wide open for attractive financing. So, they have been able to finance. They've been able to get things done, I guess is the way I would characterize it. The second thing is, as I mentioned, coming out of COVID, strategic repositioning is key. And so, it's not that smaller companies or those with balance sheet insufficiency have not wanted to do deal. It's just either they haven't been able to get the financing. Or it's just been too expensive for them to get the financing to do it.

And so, large strategics have said now's the time. The strategic imperative is there. And my board, my shareholders, are encouraging me to consolidate. And we've seen those moves happen.

The other piece, I would say, on large corporates, again, is that their fundamentals remain quite strong. And so, when you think about confidence, which is the number one driver of big, strategic M&A, the confidence in the underlying business fundamentals remains strong. And we have lived in a world of tremendous volatility and what I'll call risk for many years.

You know, we think about COVID and we think about global instability. And so, usually those have a big impact on deals not happening in the large side. But boards and companies are looking through what I'll call near/medium term instability and thinking about the long-term strategic positioning. And that's why you're seeing large strategic transactions continue straight through this period.

Allison Nathan: And the activism landscape has also remained active. It's continued to evolve. What could the next wave of activist campaigns look like, Mark?

Mark Sorrell: Yeah. I think it's a great point. And I think it's undoubtedly through 2022. One of the interesting things about what Stephan and I see is that in previous downturns or periods of market volatility, activity by activists has declined. What's actually happened in 2022, even as markets have become more volatile and declined, is activism activity has gone up globally. We've seen that in the US. We've seen it in Europe. We've seen it in Asia.

We've also seen a skew to larger campaigns. So, attacks on larger companies really at a record level. If you look at the number of campaigns on companies with a market cap above $10 billion. And that's a different phenomenon than we've seen in the past. And we think that will continue.

If you look at the funds, the AUM for activist funds, it's growing. The number of new activists is growing. The industry focused of activists is broadening. And the themes this year are slightly different in the themes this year to the past. Operational improvement in this environment is a big focus for activists for obvious reasons. Balance sheet or capital return or capital allocation is a big focus given we made the point around, broadly, how well capitalize many companies are. There's a focus on portfolio as well, or said another way, the gap between some of the parts and market value, which as equity markets have declined for many clients has opened up. So, the focus on where the portfolio should be simplified to release value.

I think the other point to mention is, you know, we've had the universal proxy come into place this year in September. And that is another catalyst for a different dynamic in many of these campaigns. So, I think broadly speaking, those are some of the differences this year.

And I think then you overlay, there's an intersection with ESG as well whereas we know there have been a number of activists focused on ESG-specific campaigns or with ESG as an element of the activist attack. And that's another overlay which can be very challenging. And this is an area where we're spending a huge amount of time with our clients preparing our clients for these kinds of scenarios.

Allison Nathan: We've spent a lot of time talking about the importance of stability and confidence in seeing the M&A activity pick up, the areas of the market that have suffered in the second half of 2022. What are you watching to gauge that stability and that confidence?

Stephan Feldgoise: That's interesting. It used to be a very simple correlation to just graph a survey of CEO confidence and correlate it to the M&A market. It still applies. But I would say it's become one of several factors versus the absolute, preeminent factor.

Very significant events like COVID are very low probability, or thought of to have very low probability. As we've gone through the last several years, the incidents of what we'll call rare risks or black swan risks seem to be happening more and more frequently. Whether that's COVID. Whether that's geopolitical instability. So, confidence now spans how do I feel about my positioning relative to what might be a black swan event that might happen in the next five years? Do I feel confident that I've built my foundation, my scale, my infrastructure, my supply chain so that I can withstand a black swan event versus just saying how do I feel about my earnings this quarter or next quarter? Those are both measures of confidence.

I would say the prior, where you think about the foundational drivers of your business and the infrastructure you have, has taken preeminence in driving M&A versus a near term focus on do I feel confident that my revenues and my earnings are going to hit next quarter's forecasts or the analyst street expectations? It's a very, I'd say, palpable and different shift.

I would say confidence, which is still the same driver, has become a very different definition than maybe the simplistic definition which was just how does my CEO feel about my near-term performance?

Allison Nathan: Mark, do you have anything to add about that as you think about 2023? What are you watching to gauge whether the pace of activity will rise?

Mark Sorrell: I think for me, the number one factor by far is financing market and how well it's functioning. I think given the amount of liquidity that corporates and private equity both have, I think that liquidity will serve to oil the M&A market. Then we will see valuations start to settle down and we will see, I think, maybe a recovery in the amount of activity that surprises in terms of how strongly it comes back.

Stephan Feldgoise: I would also add there are some fundamental drivers of capital and capital investment that the world is facing over the next several decades that are extraordinary relative to any measures of past. And I would highlight one in particular, which just is the energy transition in infrastructure, whether it be transportation, whether it be energy production. Obviously, we've had some extraordinary news in and around fusion. But the amount of capital that's going to need to be invested globally as the world transitions our energy base is extraordinary. And it's not measured in billions. It's measured in trillions.

And so, those kinds of things, when you think about big, strategic shifts in the world, and the capital required, how do companies position themselves to create value for their shareholders in delivering those needs of the world? And we're facing an extraordinary amount of capital need.

But when you look again at the underlying drivers, financing is going to come back. It's a question of when. Because the world needs investment. And to make those investments, the capital has to be provided to where the opportunity sits. Some of that will flow through M&A where companies say, all right, I need this business or this asset or this supply chain or this geography given the demands of the world, both from population as well as energy infrastructure. Whatever it might be.

And so, those are real, fundamental drivers. And Mark and I remain quite optimistic. It might not be the first half of '23 or the first quarter or the first weeks. But as we think about long-term cycles and what has really driven an M&A boom over, not just last year, but decades, and we expect to continue, is that the repositioning and the volatility and the dynamics requiring massive investments persists. And how does capital, and this is where we play a role, how does capital get allocated? It's through financing. It's through M&A. It's through investment by private equity funds. And we sit in the middle of a lot of that activity.

When you roll it up, that's why we remain quite bullish. Again, over the near/medium term for the M&A business. Because that will be an important part of that, quote/unquote "capital allocation through corporates and private equity" that is inevitable given the needs of the world. And so, that's, as I think about the underlying drivers, probably the biggest.

Allison Nathan: Stephan, Mark, so glad you both could join us.

Stephan Feldgoise: Thanks for having us.

Mark Sorrell: Thanks, Allison.

Allison Nathan: Thanks for joining us this Friday, December 16th, 2022, for another episode of Exchanges at Goldman Sachs. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

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